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INVESTING IN MARKETABLE ALTERNATIVES

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BACKGROUND: THE ROLE OF HEDGE FUNDS

"Hedge Funds" are not an asset class

- Wilshire views hedge funds as a dynamic implementation tool used to achieve portfolio objectives, rather than a separate asset class
- Hedge funds are not homogenous and have varying levels of directionality, risk, and liquidity
- Manager structuring and selection is highly dependent on investor objectives, risk tolerances, and governance capabilities

Therefore…

- Instead of "hedge funds", we prefer the term, marketable alternatives
  - Benchmark agnostic strategies and/or funds with investment lives of < 5 years
- Instead of building a diversified portfolio of hedge fund investments (typical mentality), let's invest in a diversified set of strategies to achieve one or more outcomes which are integrated and consistent with the asset allocation policy:
  - Drive returns (Growth)
  - Hedge downside risks (Diversifiers)
  - Protect against inflation (Real Assets)

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DEFINING STRATEGY GROUPS

Wilshire recommends segregating the hedge fund universe of strategies into **Directional** and **Diversifying** groups

Directional Alternatives

- Strategies that tend to be directionally long risk assets and exhibit higher equity correlations than the global hedge fund index, though some may exhibit lower beta
- Allocations compete with traditional assets in broader portfolio
- Organized into Equity, Credit, and Multi-Asset Class categories

Diversifying Alternatives

- Strategies that rely on relative value opportunities, dynamic directional exposures, or specific market inefficiencies to generate returns.
- Generally low beta AND low equity correlations
  - Low beta/correlation does not necessarily indicate low risk
- Designed to diversify versus Policy over most rolling periods > one year
- Organized into Capital Preservation, Relative Value Arbitrage, Low Correlated Yield, and Dynamic Correlation categories

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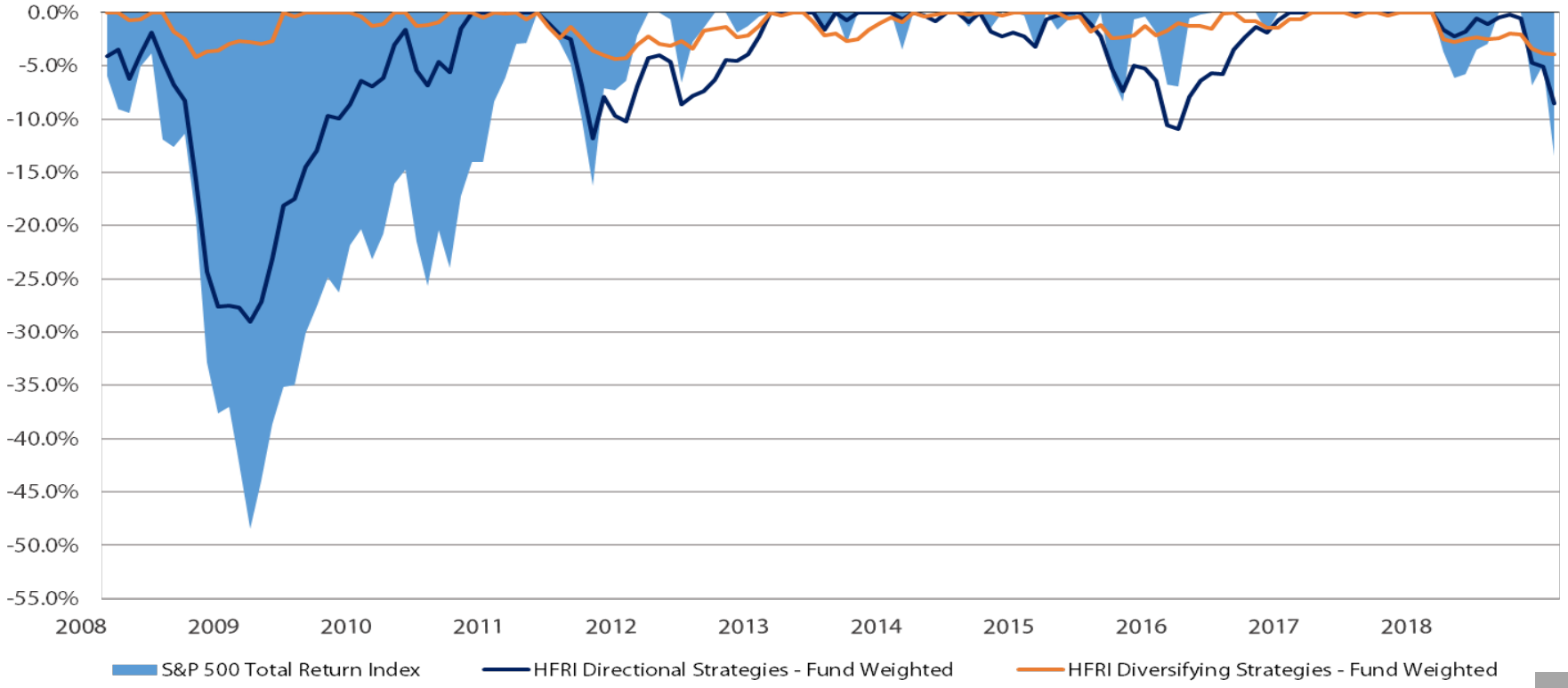
DIRECTIONAL AND DIVERSIFYING CHARACTERISTICS

To provide context around the risk characteristics of the Directional and Diversifying segments, the chart below shows the historical drawdowns of the S&P 500 Total Return Index from January 1, 2008 to December 31, 2018.

- In addition, the Wilshire Directional and Diversifying groups are also depicted to illustrate the different downside characteristics of each index relative to equities.

Drawdown Analysis: Jan 2008 – Dec 2018



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DIRECTIONAL vs. DIVERSIFYING

- The tables below provide the total return experiences of the S&P 500 Index, Barclays Global Aggregate Bond Index, Wilshire "Directional" group, and Wilshire "Diversifying" group during various time periods. Wilshire selected three bear market or challenging periods for equity markets, as well as three bull market or distinct positive periods.
- As the tables illustrate, the "Directional" group captures a significant portion of upside performance in positive equity market environments while preserving capital in periods of challenging equity market returns. The returns of the "Diversifying" group, as its title suggests, are essentially flat during the selected periods of negative equity market returns, yet the index also captures a portion of the upside during positive periods for equities. As we will reiterate shortly, manager selection is still a primary component of expected performance, and these groups only serve as very broad indicators of the different marketable alternative strategies available to investors.

Total Returns in Negative Periods for Equity Markets

From	To	S&P 500	Barclays Agg.	HFRI Directional	HFRI Diversifying
Nov-07	Feb-09	*(50.95%)*	0.69%	(29.03%)	2.95%
May-11	Sep-11	*(16.26%)*	0.97%	(11.79%)	(3.56%)
May-10	Jun-10	*(12.80%)*	(0.06%)	(5.33%)	(1.17%)

Total Returns in Positive Periods for Equity Markets

From	To	S&P 500	Barclays Agg.	HFRI Directional	HFRI Diversifying
Mar-09	Apr-11	*93.95%*	24.57%	53.44%	16.98%
Oct-11	Jul-15	*101.77%*	(0.49%)	31.84%	11.57%
Oct-15	Sep-18	*61.43%*	6.05%	23.32%	6.06%

Data source: Hedge Fund Research, Inc.

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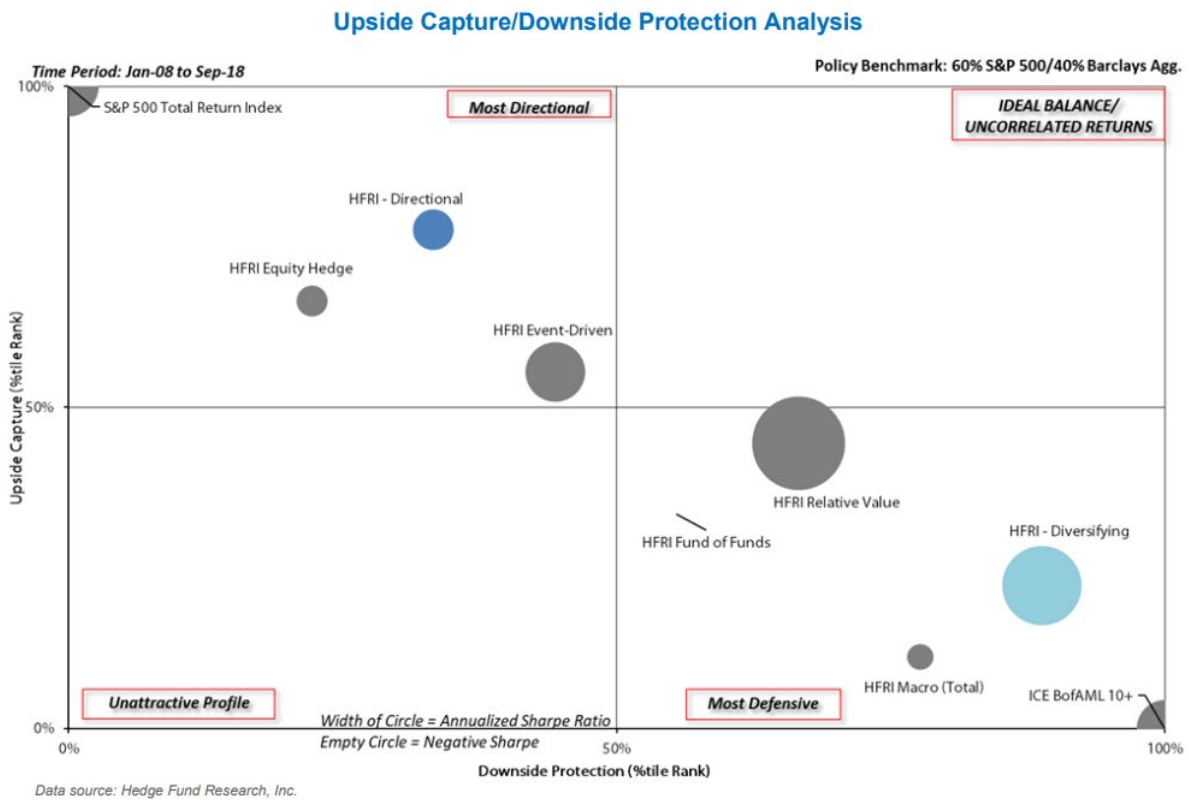
INTEGRATION

- The chart below illustrates the role of the HFRI "Directional" and "Diversifying" strategies within a simple 60/40 portfolio of equities and bonds. We have also included the traditional HFRI strategy indices for comparative purposes. More technically, the Y-axis within the chart represents Wilshire's proprietary upside capture score when the policy benchmark is positive, while the X-axis represents Wilshire's proprietary downside protection score when the policy benchmark is negative. The size of each circle within the chart represents the Sharpe Ratio of that index; the larger the circle, the higher the Sharpe Ratio.

- As the chart indicates, the "Diversifying" group represents a defensive portfolio of investments relative to a traditional portfolio of 60% U.S. stocks and 40% global bonds. In addition, the "Diversifying" group provides greater downside protection than both the HFRI Relative Value and HFRI Macro indices while generating an attractive Sharpe Ratio. Concurrently, the "Directional" group delivers greater upside capture than both the HFRI Equity Hedge and HFRI Event Driven indices while offering greater downside protection than the HFRI Equity Hedge Index.



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MANAGER SELECTION

- While reclassifying alternative investment strategies based on anticipated portfolio roles should clarify investment expectations, even those classifications can be quite broad. As a result, **manager selection is critical to success regardless of the investment framework employed**. In conjunction with individual strategy classifications according to their expected roles, Wilshire has developed and maintains a proprietary Marketable Alternatives Focus List of highly rated strategies. This list, which serves as a menu of evaluated funds/vehicles, is categorized within Wilshire's Directional/Diversifying framework for consistency. As such, the Focus List framework marries traditional strategy categories with descriptions of each strategy's intended role. The framework is illustrated below with one or more strategies/funds supporting each of the italicized categories.

Wilshire's Marketable Alternatives Focus List Framework

Directional		Diversifying	
Equity	Credit	Capital Preservation	Low Correlated Yield
Long-Biased	Alternative Yield	Equity Market Neutral	*Reinsurance*
Activist	*Direct Lending*	*Fundamental*	*Litigation Finance*
Fundamental	*Structured Credit*	*Quantitative*	Dynamic Correlation
Quantitative	Long/Short Credit	Multi-Strategy	CTA/Trend Following
Medium Net	*Distressed*	*Event-Driven*	*Long Term*
Event-Driven	*Fundamental*	*Relative Value*	*Medium Term*
Fundamental	*Multi-Strategy*	*Risk Premia*	*Short Term*
Quantitative	Multi-Asset Class	Relative Value	*Exotic Markets*
	Equity Focus	*Merger Arbitrage*	Discretionary Macro
	Credit Focus	*Convertible Arbitrage*	Long Volatility
		Volatility Arbitrage	Systematic Macro
			FX
			Multi-Strategy
			Trend Anticipation

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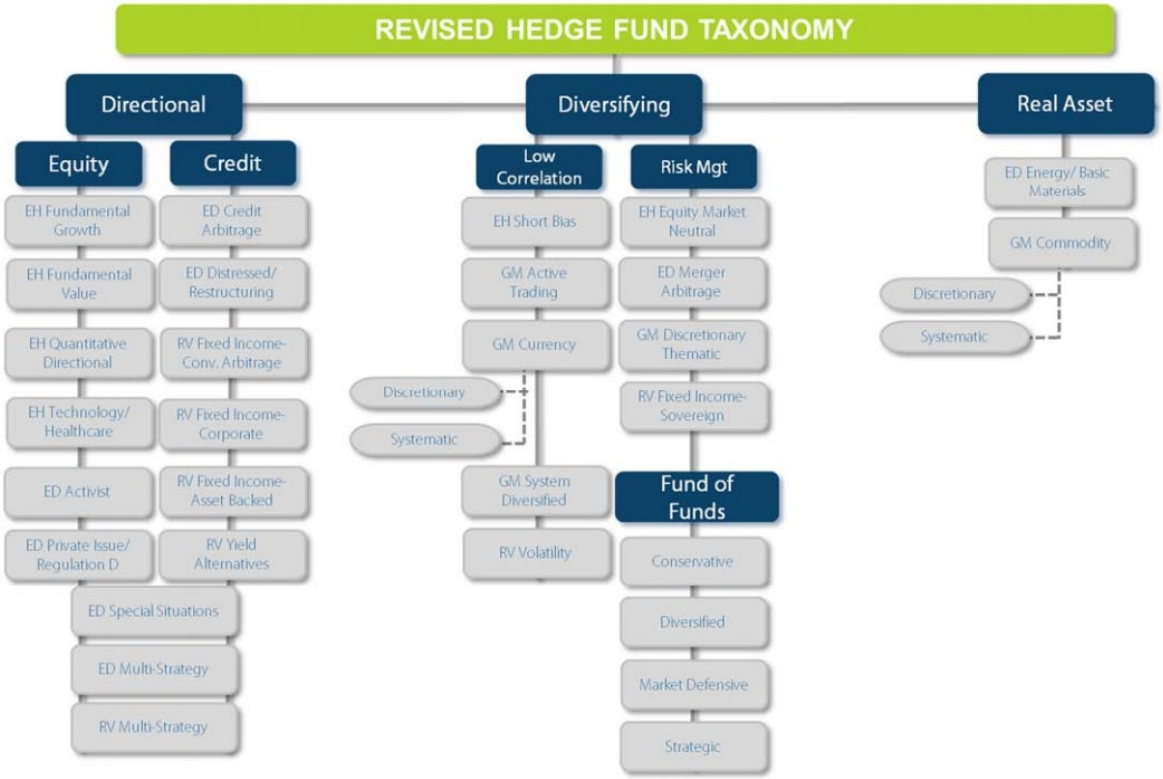
CONCLUSION

- While the hedge fund industry has progressed to become a seemingly complex universe of various structures and strategies, Wilshire has developed a simple, integrated investment framework to capitalize on the breadth of alternative investments available to our clients. Marketable Alternatives can serve various roles within a broader portfolio, such as a driver of portfolio returns or a hedge against multiple risk factors. We believe alternative investments are a key component to a diversified portfolio, and Wilshire's Directional/Diversifying framework provides flexibility and access to alternatives for a wide array of investor types and sizes.



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